Office of Chief Counsel
Internal Revenue Service

memorandum

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date: May 11, 1999

to: Chief, Examination Division, South Florida District
Attn: Revenue Agent Elodia M. Arellano

from: District Counsel, South Florida District, Miami

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subject: [redacted]
Opinion on Filing Form 3115

DISCLOSURE STATEMENT

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BACKGROUND

Rev. Proc. 71-21, 1971-2 CB 549, implements the Service's administrative decision to permit the deferral of prepayments for future services by an accrual basis taxpayer until the time of performance, but not beyond the end of the year immediately following the year of receipt. Taxpayers seeking this less taxing rule are required to file Form 3115 seeking the Service's approval to change a method of accounting. According to its representative, taxpayer has consistently reported its tuition income under the method permitted in Rev. Proc. 71-21. ([redacted]

[redacted] letter at 3 para. 2).[1]

The examining agent seeks our legal opinion on whether taxpayer must file a Form 3115 (Application for Change in Accounting Method) to avail itself of the administrative concession.

FACTS

The taxpayer [redacted] has operated as a private school since [redacted]. Taxpayer accepts three tuition payment options for the school term beginning in [redacted] of one year and ending in [redacted] of the following year: (i) [redacted]% payment in [redacted], (ii) [redacted]% in [redacted] and [redacted]% in [redacted], and (iii) [redacted]% per month. Taxpayer reports its income for tax purposes on an accrual basis, and has always deferred tuition payments for financial and tax purposes under all three options until it actually performs the services associated with the tuition payments.

DISCUSSION

Taxability of Advance Tuition Payments and Rev. Proc. 71-21 Case Law

Under the accrual method of tax accounting, taxpayer was required to include in income the tuition payments in the taxable year that all events occurred which fixed its right to receive the income and the amount of income was determined with reasonable accuracy. Treas. Reg. § 1.446-1(c)(1)(ii); § 1.451-1(a). It was taxpayer's right to receive the tuition fees at the beginning of the academic year in [redacted] that results in taxpayer's realization of that income under the accrual method of

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[1] Section 5.01 of Rev. Proc. 71-21 states that "any change by a taxpayer from his present method of including amounts in gross income to the method described in section 3.02 ... is a change in accounting method to which Section 446 and Section 481 of the code apply." Section 5.02 provides in relevant part that "taxpayers desiring to change to the method of accounting prescribed in Section 3.02 may request permission to do so by filing Form 3115 ...." The taxpayer's representative reasons that since taxpayer has always reported its tuition income under the method sanctioned by the Service in Rev. Proc. 71-21, it is not seeking to change its method of accounting for tuition payments; therefore, taxpayer is not required to seek permission to change to that method of accounting. That reasoning, correct as far as it goes, misses the point.

tax accounting. Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-185 (1934).[2]

Taxpayer's receipt of the advance tuition payments in all likelihood results in current taxation regardless of taxpayer's accounting method under the authorities cited by taxpayer's representative. Those cases, the Supreme Court's trilogy in Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957), American Automobile Association v. United States, 367 U.S. 687 (1961)and Schlude v. Commissioner, 372 U.S. 128 (1963) "establish the general rule of thumb that deferral of income for services to be rendered by an accrual basis taxpayer is not permissible for income tax accounting purposes." T.F.H. Publications, Inc. v. Commissioner, 72 T.C. 623, 641-642 (1979); Standard Television Tube Corp. v. Commissioner, 64 T.C. 238, 241- 242 (1975) (the trilogy forbid deferral of "prepaid income on the theory that it has not yet been 'earned' by the performance of services, delivery of goods, or the giving of other consideration.") (citations omitted); Charles Schwab v. Commissioner, 107 T.C. 282 (1996) (aff'd without opinion by 9th Cir.). See also, Barnett Banks of Florida, Inc v. Commissioner, 106 T.C. 103, 113 (1996) (applying Rev. Proc. 71-21 favorably to the taxpayer in that case). In the Eleventh Judicial Circuit, compensation paid in advance for future services is income when received, even where some of the income may have to be repaid because services are not rendered subsequently. United States v. Howard, 655 F. Supp. 392 (N.D. Ga.), aff'd, 855 F2d 832 (11th Cir. 1987) (criminal case).

The examining agent is advised to establish that taxpayer was entitled to the tuition fees at the beginning of the academic year. The tuition agreement between taxpayer and the students' parents presumably addresses whether the different payment plans existed merely as a financial accommodation extended to the parents, and whether the parents were entitled to partial refunds upon their children's discounted enrollment before the end of the academic year. If taxpayer was not obligated to make partial refunds, then the prepaid tuition fees are income in the taxable year of receipt even if the possibility of a refund existed. Cf. Commissioner v. Indianapolis Power &Light Co., 493 U.S. 203 (1990) (the trilogy concerned when prepayments of nonrefundable fees for services that undisputably constitued income were taxable).

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[2] Current taxation is not negated even where the taxpayer cannot presently compel payment of the money. Commissioner v. Hansen, 360 U.S. 446, 464 (1959).

Rev. Rul. 71-21

Although the Service recognizes the general rule of current taxation established by the case law, the Commissioner in Rev. Proc. 71-21 implements the administrative decision to permit the deferral of prepayments for future services by an accrual basis taxpayer until the time of performance, but not beyond the end of the year immediately following the year of receipt. Taxpayers who wish to opt the less taxing rule are required to file Form 3115 seeking the Service's approval to change a method of accounting. The taxpayer's representative asserts that taxpayer has consistently reported its tuition income under the method permitted in Rev. Proc. 71-21. ([redacted] letter at 3 para. 2).[3] But taxpayer has used the deferral method permitted by Rev. Proc. 71-21 without the Service's permission. This is a key point not discussed in the [redacted] legal opinion letter. As the taxpayer never requested permission to defer income under Rev. Proc. 71-21, it has improperly, albeit consistently, reported tuition income since [redacted] to date.

Taxpayer relies on Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968) for the proposition that prepaid income is not always taxable. In that case, a baseball team reported only the receipts for advance ticket sales for games that could be played in the taxable year. Advance receipts that related to games to be played in the following taxable year were deferred. Relying on the Supreme Court trilogy, the Tax Court held that the advance receipts were includable in income when received. The Seventh Circuit reversed, holding that the Supreme Court cases did not create a per se rule against deferral of prepaid income. 400 F.2d at 985. The appellate court found that the taxpayer's method clearly reflected income since the baseball schedule permitted an exact matching of income and expenses. The Supreme

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[3] Section 5.01 of Rev. Proc. 71-21 states that "any change by a taxpayer from his present method of including amounts in gross income to the method described in section 3.02 ... is a change in accounting method to which Section 446 and Section 481 of the code apply." Section 5.02 provides in relevant part that "taxpayers desiring to change to the method of accounting prescribed in Section 3.02 may request permission to do so by filing Form 3115 ...." The taxpayer's representative reasons that since taxpayer has always reported its tuition income under the method sanctioned by the Service in Rev. Proc. 71-21, it is not seeking to change its method of accounting for tuition payments; therefore, taxpayer is not required to seek permission to change to that method of accounting. That reasoning, correct as far as it goes, misses the point.

Court decisions were distinguished due to the taxpayer's inability in those cases to precisely match income with the services which generated the income:

> The uncertainty stressed in those decisions is not present here. The deferred income was allocable to games which were to be played on a fixed schedule. Except for rain dates, there was certainty. [4] We would have no difficulty distinguishing the instant case in this respect.

400 F.2d at 984.

Even under Artnell Co., a taxpayer must show that the income deferred is recognized as the services are rendered and the correlative expenses incurred. Chesapeake Financial Corporation v. Commissioner, 78 T.C. 869 (1982). Your memorandum of April 16, 1999, does not indicate whether taxpayer has made this showing to the examining agent. In any event, the Tax Court has limited Artnell Co. to cases where the facts present a certainty of performance or fixed dates. Johnson v. Commissioner, 108 T.C. 448 (1997) (automobile dealerships' escrow deposits taxable on the facts). Artnell Co. is not binding if [redacted] were to litigate within the venue of the Eleventh Circuit Court of Appeals, such as if place of trial in a Tax Court case were requested in Miami, Florida, or if the tax were paid and a refund suit were instituted in the Southern District of Florida. The Eleventh Circuit has not had the opportunity to consider the correctness of the Artnell Co. opinion. Accordingly, you could raise the issue in this examination.[5]

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[4] Taxpayer could also have cited Boise Cascade v. United States, 530 F.2d 1367 (Ct. Cl. 1976), a case in which an accrual basis taxpayer in the business of rendering engineering services often billed and received payment before rendering the services. Like [redacted], the taxpayer in that case did not include the prepaid amounts in income until the services were performed. The court held that there was an accurate matching of costs and income because the contractual obligations were fixed and definite, the services were not dependent upon client demand or request, and the costs of producing the revenue were incurred at the time the services were performed. Thus, there was no material distortion of income under the taxpayer's method.

[5] This assumes that the facts are properly developed, and that they do not suggest or require a different result.

Service's Right to Change Taxpayer's Method of Accounting and Assert Income Tax Deficiency in the Year of the Change for Years Otherwise Closed by the Statute of Limitations

The Service has authority under I.R.C. § Section 446(b) to change a taxpayer's overall method of accounting for income (or for an item affecting income) if the taxpayer's method does not clearly reflect income. Treas. Reg. § 1.446-1(a)(1); Sandor v. Commissioner, 62 T.C. 469 (1974), aff'd, 536 F.2d 874 (9th Cir. 1976). Under the provisions of § 481, the Service could change taxpayer's method of accounting for tuition payments from the incorrect method used by taxpayer (based on financial accrual accounting) to the correct method taxpayer should have used (premised on tax accrual accounting). Since taxpayer is not filing a Form 3115 seeking to change its method of accounting for prepaid tuition, the change in accounting method would be required by the Service, and would be made in the first taxable year under examination not barred by the statute of limitations; the adjustments would be limited to those resulting from the change in the method of accounting. In fairness to taxpayer and the Service alike, Section 481(a)(2) requires every adjustment be made that prevents "amounts from being duplicated or omitted." Buyers Home Warranty Co. v. Commissioner, T.C. Memo. 1998-98 (J. Raum).

Said differently, the Service could determine a deficiency that results from reversing the taxpayer's deferral of prepaid tuition beginning in taxable year [redacted] to the earliest taxable year not barred by the limitation statute. The "spreadback" provisions in § 481(b) impose a heavy burden on a taxpayer to establish what his taxable income for the years preceding the change would have been under the new method of accounting. If successful, the taxpayer could spread the omitted income and resulting tax over the previous years under the new method of accounting. See generally, Rankin v. Commissioner, 81 AFTR2d Par. 98-487 (9th Cir. 1998).

CONCLUSION

Taxpayer is not required to file a Form 3115 because it is not seeking to change its method of accounting for advanced tuition payments. Although it appears the Service could change taxpayer's method of accounting to tax the original partial omission of advanced tuition fees over the years, it is not recommended that you do so, since taxpayer has consistently used a method of accounting explicitly sanctioned by the IRS in 1971. An IRS adjustment going back to years prior to 1971, although legally permissible, would not only be administratively burdensome, it could also be misconstrued by the taxpayer, and

eventually the public at large, as [redacted].

If you have any question, or would like additional assistance, please feel free to call the undersigned.

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